Nos. 8850 and 8851

United States Circuit Court of Appeals

For the Sixth Circuit

JAMES A. RHEINSTROM, Executor under the Will of Minna W. Rheinstrom, Deceased,

Appellant,

v.

THOMAS J. CONNER, Collector of Internal Revenue,

Appellee.

FIRST NATIONAL BANK, Cincinnati, Ohio, Trustee under the Will of Karl Kiefer, Deceased,

Appellant,

v.

THOMAS J. CONNER, Collector of Internal Revenue,

Appellee.

BRIEF FOR THE APPELLEE.

On Appeals From The District Court of The United States For The Southern District of Ohio.

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UNITED STATES CIRCUIT COURT OF APPEALS
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No. 8850

JAMES A. RHEINSTROM, Executor under the Will of Minna W. Rheinstrom, Deceased,

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FIRST NATIONAL BANK, Cincinnati, Ohio, Trustee under the Will of Karl Kiefer, Deceased,

Appellant,

v.

THOMAS J. CONNER, Collector of Internal Revenue,

Appellee.

ON APPEALS FROM THE DISTRICT COURT OF THE UNITED STATES FOR THE SOUTHERN DISTRICT OF OHIO.

BRIEF FOR THE APPELLEE

OPINION BELOW

The findings of fact, conclusions of law and opinion of the District Court for the Southern District of Ohio (R. 60-67) are reported in 33 F. Supp. 917.

JURISDICTION

These are appeals from the judgments of the District Court entered on September 26, 1940. (R. 67-68, 88.) Notices of appeals were filed on September 27, 1940. (R. 68, 88.) The jurisdiction of this Court is invoked under Section 128 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether distributions by a corporation made in 1934 to appellants (or appellants' testators) were taxable as dividends or exempt from income taxation as returns of capital or as distributions in partial liquidation, under the provisions of Section 115 of the Revenue Act of 1934.

STATUTES AND REGULATIONS INVOLVED

These will be found in the Appendix, *infra*, p. 23.

STATEMENT

These actions are for recovery of additional income taxes and interest for the calendar year 1934, assessed against and paid by Minna W. Rheinstrom, in the amount of $24,528.39 (R. 6), and First National Bank of Cincinnati, Ohio, trustee under the will of Karl Kiefer, deceased, in the amount of $1,310.95 (R. 86), with legal interest on the amounts from the respective dates of payments thereof. The actions were not submitted to the District Court together, but they grew out of the same set of facts and were treated as one, the findings of fact and conclusions of law expressly being made applicable to each case by the District Court. (R. 60, 87.) The cases were

submitted to the District Court on the pleadings, agreed stipulation of facts and oral testimony, a jury being waived. (R. 60.) Oral testimony (R. 20-58) was taken only in case No. 8850 (No. 5191, At Law, in the court below). The pleadings (R. 1-13, 71-79) and stipulations of facts (R. 13-19, 58, 79-87) were similar in all respects essential to the issues in the cases, varying only in such matters as capacity to sue, jurisdictional prerequisites, amounts and dates of payments of taxes, etc., none of which were in dispute. The parties stipulated that there should be but one record to be used on appeal in both cases so that unnecessary duplication might be avoided for the convenience of this Court and the parties. (R. 89.)

The formal facts are, briefly:

CASE NO. 8850

The appellant brought this action for recovery of additional income taxes and interest paid for the calendar year 1934 by Minna W. Rheinstrom, in his capacity as the executor of Mrs. Rheinstrom's estate. (R. 13.) Minna W. Rheinstrom filed an income tax return for the calendar year 1934 showing a tax due in the amount of $5,484.74. (R. 14.) The appellee (R. 13) required her to file an amended return for 1934 to include as income therein $61,000 she had received during 1934 from Karl Kiefer Machine Company, and to pay additional income tax and interest amounting to $24,528.39 (R. 14). After payment of the tax and interest Minna W. Rheinstrom filed a timely claim for refund thereof with interest. (R. 18-19.) The Commissioner of Internal Revenue rejected the claim for refund (R. 19) and this action was then timely commenced (R. 1).

CASE NO. 8851

The appellant brought this action for recovery of additional income taxes and interest for the calendar year 1934, paid by it as trustee under the will of Karl Kiefer, deceased. (R. 79-80, 85.) The appellant, as trustee, filed an income tax return for the year 1934 but did not list as income $20,333.33 received from The Karl Kiefer Machine Company. (R. 84-85.) The appellee (R.2) required the appellant to file an amended return for 1934 to include as income therein the amount of $20,333.33 received from The Karl Kiefer Machine Company, and to pay additional income tax and interest amounting to $1,310.95 (R. 85). After payment of the tax and interest the appellant filed a claim for refund thereof with interest. (R. 85-86.) The Commissioner of Internal Revenue rejected the claim for refund (R. 86) and this action was then timely commenced (R. 71).

The facts applicable to both cases as found by the District Court are substantially as follows:

The Karl Kiefer Machine Company, an Ohio corporation, was organized in 1908 with an authorized capital of $500,000, consisting of 3,000 shares of common stock, par value $100, and 2,000 shares of preferred stock, par value $100; 1,500 shares of common stock and 420 shares of preferred stock were fully paid up, issued and outstanding, the total paid-in capital being $192,000; as of November 30, 1914, Karl Kiefer, now deceased, was the owner of 748 shares of the common stock and Minna W. Rheinstrom, now deceased, was the owner of 748 shares of the common stock, the remaining four shares of common stock being in the names of others to qualify them as directors, and on that date, pursuant to notice, the directors au-

thorized a reduction of the capital stock from $500,000 to $70,000, reducing the authorized preferred stock to $42,000 (the amount previously issued) divided into 420 shares of $100 par value each, and $28,000 of common stock divided into 280 shares of $100 par value each, and a certificate of reduction of capital stock was filed in the office of the Secretary of State of Ohio to that effect; each owner of common stock thereupon received new certificates for 138 shares of common stock in exchange for the original 748 shares. The reduction of the capital stock by cancellation of the original common stock and the issuance of the new stock was reflected on the books of the company by reducing the value of the common stock account from $150,000 to $28,000 and transferring the $122,000 to the surplus and undivided profits account, which then was $31,006.80, making a total of $153,006.80; in 1921, the $122,000 was again transferred to a new account, "paid in capital," but no actual distribution of any kind was made, no physical segregation of assets, nor was any other action in regard to the capital stock reduction taken until 1934, when the company, in addition to the payment of a dividend of $90,000, disbursed the $122,000 and cancelled the "paid in surplus" account, designating this payment as one which arose by the reduction of the common stock in 1914. The $122,000 was distributed as follows: $61,000 to Minna W. Rheinstrom and $61,000 to the beneficiaries under the will of Karl Kiefer, one-third, $20,333.33 to the First National Bank, as trustee under the will of Karl Kiefer, one-third to Adele W. Kiefer, Karl Kiefer's widow, and one-third to brothers and sisters of Karl Kiefer. (R. 60-62.)

The earnings of The Karl Kiefer Machine Company for the year 1934 were more than sufficient to pay the $90,000 dividend and the $122,000, the item in issue in this action. (R. 62.)

The earnings of The Karl Kiefer Machine Company for the years 1910, 1911, 1912 and 1913, were $148,006.80, out of which dividends of $87,000 were paid. (R. 63.)

The District Court also found that there was no real change in the stockholders' position with respect to the company when the 1,220 shares of common stock were cancelled in 1914; that Karl Kiefer owned all of the preferred stock before 1914; that before 1914 Karl Kiefer owned 748 shares of the common stock (1/2) and Minna W. Rheinstrom owned 748 shares (1/2); that after the change Karl Kiefer still owned all of the preferred stock and 138 shares of common stock (1/2) and Minna W. Rheinstrom still owned one-half of the common stock (138 shares); that since there was no reduction in the assets of the company and no segregation or distribution of any kind the 138 shares of common stock owned each by Karl Kiefer and Minnie W. Rheinstrom actually represented the same proportionate interest as had the 748 shares formerly owned by each; that in 1934, twenty years after the change in numbers of shares held by the stockholders, Minna W. Rheinstrom and the Karl Kiefer estate still owned the same proportion of common stock subject, in 1934 as in 1914, to the 420 shares of preferred stock (R. 63); that when the common stock was reduced from 1,500 shares to 280 shares and the 1,220 shares of common cancelled the transaction was reflected on the books by merely reducing the common stock value account from $150,000 to $28,000 and increasing the surplus account by the difference of $122,000; that there was no reduction or liquidation of assets, or segregation thereof, or distribution of any kind ordered or made (R. 65); that this transaction did not alter the pre-

existing proportionate interest of any stockholder and that the new certificates of common stock issued to Minna W. Rheinstrom and Karl Kiefer merely decreased the number of shares with proportionate enhancement of the value of each share (R. 66); that in the reduction in the number of shares of capital stock and the transfer of $122,000 to surplus at the expense of the capital stock account nothing was done remotely suggesting a partial liquidation; that on the contrary, the $122,000 was retained in the business actively working for twenty years and helping to produce the corporation's constant earnings and dividends (R. 67).

The District Court concluded as matters of law: That the net earnings of The Karl Kiefer Machine Company in 1934 were more than sufficient to pay the ordinary dividend of $90,000 and the item of $122,000 in issue; that the appellants failed to sustain their burden of proof; and that the payment of $122,000 to stockholders was a distribution taxable as dividends under the provisions of the applicable internal revenue laws. (R. 67.)

The judgments for the appellees were entered on September 26, 1940, in accordance with the District Court's findings of fact and conclusions of law, and these appeals followed.

SUMMARY OF ARGUMENT

The revenue laws define a dividend as any distribution made by a corporation to its stockholders out of earnings and profits and create a conclusive presumption that any distribution is made out of the most recently accumulated earnings. The earnings of The Karl Kiefer Machine Company in 1934 were sufficient to cover all distributions in-

cluding the amounts involved in these cases. Accordingly, the action of the Commissioner of Internal Revenue in holding the distribution taxable as dividends was in strict accordance with the law.

A distribution need not be called a "dividend" in order to be taxed as such and neither book entries, names or the corporate intention prevail against the statutory presumption.

The distributions in 1934 were not in payment of stock cancelled in 1914. The number of authorized shares of common stock of the corporation was reduced in 1914. The actual capital structure, however, was not affected. No money or assets was distributed or segregated and no other action was taken with regard to the claimed capital stock reduction. The original capital remained in the corporation actively working and earning dividends throughout the period 1914 to 1934. The only change that was made was in bookkeeping. The capital stock account was reduced from $150,000 to $28,000, and the difference of $122,000 was set up as surplus.

The District Court did not err in excluding proffered testimony relating to the background and purpose of the directors in reducing the number of shares and the claimed agreement to pay therefor. The testimony was largely hearsay, opinion, or irrelevant. If there was technical error in excluding evidence it was harmless because the court's findings show that the evidence was, in fact, carefully considered.

The corporation did not become obligated as a matter of law to repay the value of shares surrendered in 1914. The distribution in 1934 was not in satisfaction of such an obligation. There was an apparent but no real reduction

in capital structure in 1914. The capital investment remained constant. The number of shares merely was reduced with consequent enhancement of value of each share. The preexisting proportionate interests of the two common stockholders was not altered by the reduction in number of shares. Each stockholder was entitled to the same dividends as before the change. The only possible change was in the proportionate distribution of assets upon complete dissolution. That would not affect the question whether there was a return of capital in payment of stock.

The distribution in 1934 was not in payment for stock redeemed in 1914 as a partial liquidation. The question whether a distribution is in partial liquidation is one of fact. The District Court's finding that there was no partial liquidation should not be disturbed as there was no evidence upon which the court could make a different finding.

ARGUMENT

I

The Distributions to the Stockholders in 1934 Were Taxable as Dividends Since the Accumulated Earnings of the Karl Kiefer Machine Company in 1934 Were More Than Sufficient to Pay All Distributions Made.

The applicable revenue law (Section 22 (a) and (d) of the Revenue Act of 1934) expressly provides that dividends shall be included in gross income and that distributions by corporations shall be taxable to the shareholders as provided in Section 115 of the Revenue Act of 1934. Section 115 (a) and (b) of the Revenue Act of 1934, Ap-

pendix, *infra*, provides that the term "dividends" means any distribution made by a corporation to its stockholders out of earnings or profits accumulated after February 28, 1913, and that every distribution is made out of the most recently accumulated earnings or profits. The statute thus creates a conclusive presumption that any distribution is made from the most recently accumulated profits and hence the corporation may not allocate such distribution to any other fund so long as the earnings are sufficient to cover the payments.

It is undisputed that the earnings of The Karl Kiefer Machine Company for 1934, prorated to each dividend payment date, plus earnings of the corporation accumulated since February 28, 1913, and on hand January 1, 1934, were more than sufficient to cover all payments made to the stockholders during 1934. (R. 18, 62, 84.) Accordingly, the appellee submits that the action of the Commissioner of Internal Revenue in holding that the distribution of $61,000 and $20,333.33, made by The Karl Kiefer Machine Company in 1934 to Minna W. Rheinstrom and First National Bank, Trustee, respectively, were taxable as dividends, and in rejecting the claims for refunds of additional income taxes assessed thereon (R. 14, 19, 85, 86) was strictly in accord with the provisions of the internal revenue laws. The decided cases sustain the appellee's position. *Douglas* v. *Edwards*, 298 Fed. 229 (C. C. A. 2d), reversed on another point, 269 U. S. 205; *Leland* v. *Commissioner*, 50 F. (2d) 523 (C. C. A. 1st), certiorari denied, 284 U. S. 656; *Hadley* v. *Commissioner*, 36 F. (2d) 543 (App. D. C.); *Christopher* v. *Burnet*, 55 F. (2d) 527 (App. D. C.); *Lincoln Nat. Bank* v. *Burnet*, 63 F. (2d) 131 (App. D. C.); *Faris* v. *Helvering*, 71 F. (2d) 610 (C. C. A. 9th), certiorari denied, 293 U. S. 584; *Walker* v.

Commissioner, 26 B. T. A. 494, petition for review dismissed without opinion, 74 F. (2d) 1022 (C. C. A. 9th), and cases cited in the above opinions.

Moreover, a distribution need not be called a "dividend" in order to be taxable as such, and neither book entries, names, nor the corporate intention prevail against the statutory presumption. Thus, in the case of *Leland* v. *Commissioner, supra*, the directors of the corporation intended and understood that they were distributing a part of the paid-in surplus or capital, not dividends; in *Faris* v. *Helvering, supra*, the distribution was intended to be out of capital assets; in *Lincoln Nat. Bank* v. *Burnet, supra*, the directors considered the distribution, in part, a gift; in *Anketell Lumber & Coal Co.* v. *United States*, 1 F. Supp. 724 (C. Cls.); *Christopher* v. *Burnet, supra*, and in *Chattanooga Sav. Bank* v. *Brewer*, 17 F. (2d) 79 (C.C.A. 6th), certiorari denied, 274 U. S. 751, it was contended that the distributions were loans. Nevertheless, it was held in all of these cases, and many similar cases which might be cited, that the distributions were taxable dividends since the corporations had earnings accumulated after 1913 sufficient to pay the distributions.

The necessity for the statutory presumption upon which the appellee relies, its essential justice and validity, and its repeated acceptance by the courts, is succinctly explained in the case of *Leland* v. *Commissioner, supra*, where the court said (p. 525):

> Nor do we think that Congress exceeded its constitutional power by providing that, so long as a corporation has on hand earnings and profits accumulated since 1913, any distribution to its stockholders should be conclusively presumed to be a dividend out of such earnings or profits. It is evident that Congress intended that a stock-

> holder, to whom distributions were made while a corporation had earnings or profits on hand, should not escape the burdens of the income tax law through the directors of the corporation undertaking to make distributions from some other source. The statute does not convert what is not income into income. It simply requires that, while there are earnings or profits, the distributions to the stockholders shall be made from such earnings or profits, and any distributions made while such earnings or profits exist shall be deemed to have been so made.

We feel that upon consideration of the conclusive presumption created by the statute this case should be ended and that even if there was an obligation created in 1914 to repay the stockholders when the number of common shares was reduced that it could not be treated for tax purposes in 1934 as paid from capital so long as there were earnings available for distribution in 1934. However, in view of the fact that the reduction in stock did not substantially affect the two individuals who held all of the common stock in equal proportions we do not concede that there was any duty on the corporation to reimburse the stockholders.

II

The Distributions Were Not Returns of Capital Through Redemption of Stock Either by Express Understanding or by Operation of Law and They Were Not Distributions in Partial Liquidation.

In an attempt to avoid the provisions of Section 115 (a) and (b) that corporate distributions are taxable dividends where there are earnings available for distribution,

the appellants advance several alternative contentions. First, it is contended that the reduction in 1914 in the number of shares held by each of the two common stockholders created a surplus of $122,000, which represented capital originally paid for the cancelled shares; that it was understood that this capital would be paid to the stockholders on demand, and that the distribution in 1934 fulfilled the corporation's obligation. (Br. 7-14.)

The fallacy in this argument is that it assumes that there was intended *and accomplished* an actual change and reduction in the corporation's capital structure and an actual change in the stockholders' position with respect to the corporation. The appellee contends and the court below held that there was effected no real change in those respects. The record establishes conclusively that from 1914 through 1934 there was no change in the corporation's capital structure by reason of the reduction in the number of outstanding shares of common stock. Whatever may have been the original purpose or intention for reducing the number of shares it stands undisputed that throughout that twenty-year period the $122,000 in issue remained undistributed, unsegregated and actively employed in the corporation's business. (R. 64-65). Moreover, the books and records of the corporation contain no acknowledgment of any debt owing to the stockholders (R. 46) and no interest was ever paid to them (R. 50).

It is true that after the reduction in the number of common shares in 1914, the books were set up differently. The common stock account was reduced by $122,000 and the regular surplus and undivided profits account was increased by the same amount (R. 61), and then again in 1921 the $122,000 was transferred to a new account designated as paid-in surplus (R. 49, 61). But in neither case was there any distribution, segregation of assets or any

other action taken in regard to the purported capital stock reduction. Taxation is a practical matter concerned with substance, not form. What actually happened, not bookkeeping entries or designations, controls in tax cases. What actually happened in this case from 1914 through 1934, so far as the reduction of common shares affected the corporation's capital structure, was precisely nothing. The actual capital investment in the corporation was not reduced in 1914; it was merely divided into two accounts on the books, capital stock, $28,000, and surplus, $122,000, whereas, formerly, there had been carried only one account, capital stock, $150,000. The stockholders did not pay in the $122,000 as "surplus", "paid-in surplus", or "paid in capital surplus", as successively designated on the books. The item was set up on the books by subtracting it from the original common stock account. The stockholders' investments did not change but remained constant regardless of the book entries. The fact that $122,000 of the $212,000 distributed to the stockholders in 1934 was charged against the "paid-in surplus" account to close it out does not alter the substance of the transaction. There were then on hand earnings accumulated since 1913 out of which the distribution was made. No actual capital, as originally paid into the company, was distributed to the stockholders. It is to be recalled that even after the $212,000 of distributions were made in 1934 there still remained a surplus of more than $390,000 (R. 51), still huge in proportion to the original capital investment of $192,000.

In the light of what actually transpired it is exalting form over substance to urge that common stock was cancelled in 1914, a fund created for the actual redemption thereof by payment whenever demanded, and the fund allowed to remain unsegregated, undistributed, bearing

no interest but working in the corporation's business, until after a lapse of twenty years (when the corporation's accumulated earnings had reached very large proportions), it was decided to pay off the obligation.

The appellants argue at length that the District Court erred in rejecting testimony offered relating to the background and purpose of the directors in reducing the number of common shares and the claimed agreement to pay therefor upon demand. (Br. 7-14.) At the trial there was a rather extended discussion among the court, counsel for both parties, and appellants' witness, James A. Rheinstrom, in this connection. (R. 29-34, 41.) Examination of this portion of the record, we believe, will demonstrate that the District Court's rulings were correct, as much of the testimony proposed was flagrant hearsay and opinion evidence not admissible in any court. Moreover, since the controlling factor in this case is what was actually done rather than the purpose of the directors, their intent becomes irrelevant and immaterial. The books and records of the corporation were in evidence (appellants' Exhibits 1, 2, 5, 6A, 6B, 7, 8, 9, 10, and appellee's Exhibits A, B, C, D, and E (R. 35, 38-39, 42, 43, 52, 53)), and they accurately reflected everything that was done in connection with the reduction in the number of common shares. The testimony offered by the appellants could neither vary the effect of the actual transaction, nor aid the court in determining what was done or the reasons therefor. While it is true, as the appellants state (Br. 9), the cast of subdivision (a) of Rule 43, Federal Rules of Civil Procedure, is toward admissibility, rather than exclusion, of testimony, it is still the universal rule of federal courts that flagrant hearsay and opinion evidence and evidence clearly inadmissible as irrelevant and im-

material, shall be excluded. Moore's Federal Practice under the New Federal Rules (1938), Vol. 3, Section 43.02.

Even if it be assumed that the District Court was in error in excluding part or all of the testimony proffered by the appellants relating to the reduction in the number of shares of common stock, it is obvious that the error was harmless. Rule 61 of the Federal Rules of Civil Procedure is as follows:

> Rule 61. *Harmless Error.* No error in either the admission or the exclusion of evidence and no error or defect in any ruling or order or in anything done or omitted by the court or by any of the parties is ground for granting a new trial or for setting aside a verdict or for vacating, modifying, or otherwise disturbing a judgment or order, unless refusal to take such action appears to the court inconsistent with substantial justice. The court at every stage of the proceeding must disregard any error or defect in the proceeding which does not affect the substantial rights of the parties.

The formal proffer of evidence which the appellants insist was erroneously rejected is included in the following extract from the record (pp. 31-32):

> MR. GOLDMAN: If the witness were permitted to answer the question he would say that prior to the time the stock was reduced in 1914 Karl Kiefer, who was then the head of the Karl Kiefer Machine Company and who guided its policies, desired to make free for the stockholders a large portion of the then paid-in capital of the corporation, as the directors of the company considered the company at that time over-capitalized; that Karl Kiefer, in consultation with his uncle by marriage, Adolph Dreyer, desired to have available for the stockholders money which

had previously been paid into the company in the form of the then existing paid-in capital, which could not be withdrawn from the company without impairing the capital without a reduction in stock; that the by-laws of the company did not permit any officer or stockholder to borrow money for personal use on the company's credit; and it was determined to reduce the capital stock and thus create a fund which would be available to the stockholders at any time they wished to draw therefrom, and that the officers could then borrow money from the bank on the company's credit and have the use of the money themselves by drawing down the amount due from the reduction of the capital stock.

THE COURT: Do I understand you to say that the stockholders could then borrow money on the company's credit?

MR. GOLDMAN: To make that clear, Your Honor, the by-laws of the company provided that no stockholder or officer could borrow money on the company's credit and then use it himself, but by decreasing the capital stock and creating a liability of the corporation to the stockholders in this case to the extent of $122,000, that then the company could borrow money at the bank and the stockholders would have the right to the money to the extent of $122,000.

THE COURT: Kind of fantastic, isn't it?

* * *

However, in spite of the inherently improbable nature of the proffered testimony and its conflict with the transactions that actually occurred, and the rulings of the District Court sustaining the appellee's objections, it is evident that the learned trial judge did carefully consider the testimony offered for in the court's findings it is said (R. 62-63):

> Although the evdence as to the company's purpose, was rejected for various reasons, it may be well to consider the operations over the entire period in question, particularly in view of the fact that several exhibits were received in evidence bearing more or less on this phase of the case. Defendant's Exhibit H shows that the net earnings for the years 1910, 1911, 1912 and 1913 were $148,006.80 and dividends paid were $87,000. Considering that the company started with a paid-in capital of $192,000 in 1908 and had net earnings of $148,000 by the end of 1913, would seem to definitely dispose of the theory that the directors considered the company over-capitalized in 1914.

The District Court's findings that there never was any segregation of the $122,000 fund and no distribution or withdrawal thereof (R. 63, 65) establishes that consideration was also given to the fact that the fund was never used for the purpose for which it was claimed to have been created. We submit that the District Court did consider the proffered evidence, that the same conclusion would have been reached whether or not the evidence was rejected, and that no injustice was done to the appellants in rejecting the testimony. In such a case the judgment should not be reversed by a Circuit Court of Appeals even if there were technical error in excluding the evidence. (*American*) *Lumbermen's Mut. Cas. Co.* v. *Timms & Howard,* 108 F. (2d) 497 (C. C. A. 2d); *Woods* v. *Gettelfinger,* 108 F. (2d) 549 (C. C. A. 5th).

The appellants also contend that, as a matter of law, the corporation became obligated to repay the par value of the shares surrendered in 1914, and that the payment in 1934 was in satisfaction of that obligation and was paid out of capital made free by the cancellation. We believe

that it has been demonstrated above that this argument is founded upon false premises. Appellants cite and quote many cases upon the general proposition that when stock is surrendered and cancelled the corporation which calls in the stock must pay for it. (Br. 15-24.) We do not deny that the general rule is as stated but the rule is not applicable to the present case. Here there was an apparent but no real reduction in capital common stock or capital structure. The District Court made a very thorough analysis of the appellants' contentions in this regard and, we believe, fully refuted them. (R. 63-66.)

The number of issued shares of capital stock was reduced, of course, but, as the District Court pointed out, the effect of the transaction was merely to decrease the number of shares with consequent enhancement of the value of each share. In this connection the District Court quoted the case of *Eisner* v. *Macomber*, 252 U. S. 189, showing how aptly the language of that leading case applies to the present one and how the Supreme Court looks through and disregards mere bookkeeping entries to determine the essence of a transaction. (R. 65-66.)

The court below held that the preexisting proportionate interests of the two common stockholders of The Karl Kiefer Machine Company were not altered by the reduction in number of shares. (R. 63, 66.) The appellants contend that the court erred in that respect, advancing the possibility that upon complete dissolution of the corporation one of the stockholders, Karl Kiefer, might have distributed to him a larger proportion of the assets than he would if there had been no reduction in the number of common shares. For all practical purposes the District Court's holding was certainly correct. Before and after the change each stockholder owned the same proportion of the common stock and one stockholder always owned

all of the preferred stock. Necessarily, each stockholder continued to be entitled to the same proportion of the company's earnings and dividends. The voting rights and control of the corporation remained the same with the possible exception suggested by the appellants that one of the stockholders by reason of ownership of the preferred stock, might dictate the time of dissolution of the corporation, but even this is a *non sequitur*. The appellants cite Section 3256c of the Revised Statutes of Ohio (1906), which provides that upon submission by the directors of a corporation of an agreement to sell all of the corporation's property three-fourths of the stockholders may adopt the agreement and effect the sale. However, the preceding section of the law provides:

> Section 3256b. No corporation organized under the laws of this state shall sell its entire property and assets to any person, persons or associations, or to another corporation, whether organized for the same or similar purpose or otherwise, under the laws of this state, or any other state, unless three-fourths of the directors of such corporation shall authorize the execution of an agreement therefor prescribing the terms, considerations and conditions thereof, which considerations may be money, stocks, bonds, or other instruments for the payment of money, or any valuable consideration, nor shall any such sale be made for the formation of or to any trust or combination for the purpose of restricting trade or competition.

Thus it is seen that any agreement to sell the corporation's entire property must be initiated by three-fourths of the directors. Control of the directorate of The Karl Kiefer Machine Company was not affected by the reduction in number of common shares because the voting stock still remained equally divided between the two stockholders.

If there was a change in the proportionate shares of the assets that the stockholders might receive upon complete liquidation, by reason of the reduction in number of common shares, we submit that it would have no bearing upon the issues in this case. The transaction may have involved an inchoate gift from Minna W. Rheinstrom to Karl Kiefer, but it does not affect the question whether there was a return of capital resulting from the reduction in the number of shares.

As a final alternative the appellants contend that the distribution in 1934 was in payment of stock redeemed in 1914 as a partial liquidation. (Br. 25-30.) By this contention it is sought to bring the transaction within the purview of the exemptions found in Section 115 (c) and (i) of the Revenue Act of 1934, Appendix, *infra*. We believe that this contention requires no extended discussion. It is well settled that the question whether a distribution is in parial liquidation is one of fact depending upon the particular circumstances of each case. *Gossett* v. *Commissioner*, 59 F. (2d) 365 (C. C. A. 4th); *Hellman* v. *Helverding*, 68 F. (2d) 763 (App. D. C.); *Kelly* v. *Commissioner*, 97 F. (2d) 915 (C. C. A. 2d); *Ward M. Canady, Inc.* v. *Commissioner*, 76 F. (2d) 278 (C. C. A. 3d), certiorari denied, 296 U. S. 612; *Milton* v. *Commissioner*, 33 B. T. A. 4; *C. M. Menzies, Inc.* v. *Commissioner*, 34 B. T. A. 163.

In this case the District Court held that there was no distribution in liquidation, saying that (R. 64):

> * * * beyond the reduction in the number of shares of common stock and the transfer of $122,000 to surplus at the expense of the common stock account, nothing was done even remotely suggesting partial liquidation.

The court's finding should not be disturbed as it is supported by the evidence, or perhaps it is more accurate

to say that there was a complete lack of evidence upon which the court could make any different finding.

The appellants contend that the Commissioner of Internal Revenue has been inconsistent in asserting the tax against the First National Bank, as trustee, and granting a protest by the *cestui que trust* against whom a revenue agent had proposed a deficiency assessment. (R. 59-60, Br. 30-36.) It is argued that this implies that the Commissioner considered the distribution as a return of capital when he granted the protest of the beneficiary and as income when the deficiency was asserted against the trustee, and that it could not be both. The argument seems to be without merit. The Commissioner has certainly always insisted that the distribution was income to someone and the fact that he granted the beneficiary's protest carries no implication that he regarded the payment as a return of capital to anyone. In any event, the sole issue before this Court is whether the distribution was a taxable dividend or a return of capital, and even if the Commissioner has taken inconsistent positions it would have no bearing upon the question now presented.

CONCLUSION

The decision of the District Court is correct and the judgments should be affirmed.

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